Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1137

ARTHUR FULMAN, ET AL., TRUSTEES,
PETITIONER,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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UNITED STATES OF AMERICA,
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Petitioners, Arthur Fulman et al., Trustees, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit entered in this proceeding on November 19, 1976.

Opinions Below

The opinion of the Court of Appeals appears in Appendix A hereto. The opinion of the United States District Court for the District of Massachusetts is reported at 407 F. Supp. 1039, and a copy thereof is included in Appendix B.

Jurisdiction

The judgment of the Court of Appeals for the First Circuit was entered on November 19, 1976, and this petition for certiorari is filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. section 1254(1).

Question Presented

Whether, in determining the amount of a deficiency dividend for the purpose of calculating the undistributed personal holding company income of a personal holding company under section 545 of the Internal Revenue Code of 1954, the value of property distributed to individual stockholders should properly be taken into account at its fair market value, as Petitioner contends, or at its adjusted basis to the corporation, as Respondent contends.

Statutory Provisions Involved

Pursuant to Rule 23(1)(d), the full text of the relevant portions of the following statutory provisions are recited in Appendix C.

Sec. 541 — Imposition of Personal Holding Company Tax.
Sec. 545 — Undistributed Personal Holding Company Income.
Sec. 547 — Deduction for Deficiency Dividends.
Sec. 561 — Definition of Deduction for Dividends Paid.
Sec. 562 — Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction.
Sec. 316 — Dividend Defined.
Sec. 301 — Distribution of Property.

Statement of the Case

This is a tax refund suit involving the application of sections 541, 545, 547, 561 and 562, of the Internal Revenue Code of 1954, as amended, which impose a penalty tax on corporations which satisfy the criteria for classification as a personal holding company, and of sections 316 and 301 of said Code which affect the taxation to shareholders of corporate distributions. The tax is imposed on the undistributed personal holding company income of a corporation, which represents the taxable income as determined for corporate income tax purposes adjusted as specified in section 545. One of those adjustments is the deduction for dividends paid, including "deficiency dividends" declared and paid in a subsequent taxable year. The definition of a dividend paid for the purpose of the calculation of undistributed personal holding company income (and also for the purpose of calculating accumulated taxable income under sections 531-537) is to be found in section 561.

Petitioner filed the instant civil action in the United States District Court for the District of Massachusetts on the ground that personal holding company taxes and interest were erroneously and illegally assessed against and collected from it for its taxable years ended December 31, 1962 and December 31, 1963. Jurisdiction of that Court was invoked under 28 U.S.C., section 1346(a)(1).

Petitioners (hereinafter referred to as Taxpayer) are the successors in interest to the Pierce Investment Company, a Massachusetts corporation, which is now liquidated.

Taxpayer was determined to be a personal holding company for its taxable years ended December 31, 1962 and 1963. Pursuant to the provisions of section 547, the taxpayer distributed to its shareholders certain marketable securities as "deficiency dividends" and then filed a claim under section 547(e), valuing the distributed securities at

their fair market value, and thereby offsetting all undistributed personal holding company income for both taxable years. Respondent denied a deficiency dividend deduction for the fair market value of the securities distributed, asserting that the valuation for those purposes should only be the adjusted basis of those securities, pursuant to the provisions of Treas. Reg. 1.562-1(a). The personal holding company tax was imposed upon the difference between the adjusted basis and the fair market value of the distributed securities, that difference having been determined to be undistributed personal holding company income.

The facts were not disputed by the parties. A stipulation was entered into in the District Court for the purpose of determining the issue of the legality of Treas. Reg. 1.562-1(a). Taxpayer concedes that if Treas. Reg. 1.562-1(a) is valid, then the personal holding company tax was properly imposed upon the excess of the market value of the securities on the dates of distribution over their adjusted bases.

Both the District Court and the First Circuit upheld the validity of Treas. Reg. 1.562-1(a), for slightly different reasons.

Reasons for Granting the Writ

I. The Decision of the First Circuit Directly Conflicts With the Decision of the Sixth Circuit in *H. Wetter Manufacturing Co.* v. *U. S.*, 458 F.2d 1033 (6th Cir., 1972).

In the *Wetter* case the Sixth Circuit held that Treas. Reg. 1.562-1(a) was invalid because its content exceeded the authority granted to the Secretary of the Treasury, or his delegate, to issue regulations for the enforcement of the Internal Revenue Code. Rather, the Sixth Circuit found that the statutory pattern was clear, that said regulation conflicted with the Code, and that the property distributed to individual shareholders should be valued at its fair market value on the date of distribution. The material facts were the same in the *Wetter* case as they are in the instant case, except as to the amount of undistributed personal holding company income involved.

Further, the same issue, substantially on identical facts, has been raised in the case of *Gulf Inland Corporation* v. *U. S.* (U.S.D.C., La. 1975); on appeal to the Fifth Circuit (the case has been briefed by both parties but oral argument has not been made at this time). The District Court relied on the *Wetter* case, and thereby denied the validity of Treas. Reg. 1.562-1(a).

Taxpayer has no knowledge of other pending cases raising the same issue, and has no practical way to ascertain whether such cases are presently docketed in the District Courts, Court of Claims, or are pending before the Internal Revenue Service.

It is unfair that a different legal rule should exist in the Sixth Circuit than in the First Circuit as to taxpayers similarly situated.

II. This Same Issue Will Continue To Be Litigated Until Resolved by This Court.

The Internal Revenue Service has designated the issue involved in this case as a "prime issue", meaning that it is an issue which presents a "legal question of major importance in the administration of the internal revenue laws and which have not been tested adequately in litigation." MT 1200-143 (11/19/74) IR Manual.

The regulation affects not only the calculation of undistributed personal holding company income but also the calculation of taxable income for the purpose of determining the accumulated earnings tax, section 531 *et seq.*, Internal Revenue Code of 1954. Thus, the resolution of this dispute has applicability beyond the rather narrow scope of the personal holding company tax.

Based upon the current litigating policy of the Internal Revenue Service, the issue will continue to be litigated. The material facts will necessarily be the same in whatever forums the cases are brought, namely that property has been distributed with a value on the date of distribution which varies from its adjusted basis.

Taxpayer respectfully submits that the prospect of continued and needless litigation and the resultant uncertainty in the administration of both the personal holding company tax law and the accumulated earnings tax law justifies the grant of certiorari to review the judgment below, and resolve the issue.

III. Treas. Reg. 1.562-1(a) Represents a Dangerous Extension of the Regulation-making Power of the Secretary of the Treasury.

In none of the decided cases, *Wetter*, *Fulman*, or *Gulf Inland*, has the government successfully contended that its position in Treas. Reg. 1.562-1(a) is *supported* by statute. Rather, the Government has contended that no statute *prohibits* the result achieved by that Regulation, and that the Committee Reports on the Internal Revenue Code of 1954, both of the House and Senate, indicate that such a result was intended. Therefore, the Government justifies said regulation by reference to a Committee Report even though no statute remotely authorizes the result.

In the *Wetter* case, the Sixth Circuit found that the statutes were clear and that reference to the Committee Reports was barred, stating:

> "Like other extrinsic aids to construction, the use of legislative history is to *solve*, but not to *create* an ambiguity."

To the contrary, the First Circuit has not found the statutory pattern to be clear, and has resorted to the Committee Reports, not for interpretation of a statute, but to justify a regulation for which the First Circuit acknowledges there is no direct statutory authority. Taxpayer submits that the Government has no authority to promulgate a Regulation of major importance in the administration of the Internal Revenue Code without the mandate of the Code section under which it is to be issued.

Conclusion

For the reasons stated above, a writ of certiorari should issue to review the judgment and opinion of the First Circuit.

Respectfully submitted,

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APPENDIX A

United States Court of Appeals
For the First Circuit

No. 76-1165

ARTHUR S. FULMAN, ET AL.,
PLAINTIFFS, APPELLANTS,
v.
UNITED STATES OF AMERICA,
DEFENDANT, APPELLEE.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

Before COFFIN, *Chief Judge*,
CLARK,* *Associate Justice*, U.S. Supreme Court (Ret.),
and CAMPBELL, *Circuit Judge*.

Daniel D. Levenson, with whom *Jonathan J. Margolis*, *Mary Gallagher*, and *Lourie & Cutler* were on brief, for appellants.

Gary R. Allen, Attorney, Tax Division, Department of Justice, with whom *Scott P. Crampton*, Assistant Attorney General, *James N. Gabriel*, United States Attorney, *Gilbert E. Andrews*, and *Alfred S. Lombardi*, Attorneys, Tax Division, Department of Justice, were on brief, for appellee.

November 19, 1976

COFFIN, *Chief Judge*. The sole issue in this appeal is the validity of the Treasury regulation which provides that the amount of a personal holding company's deduction for a dividend in kind is the company's adjusted basis in the property. Appellants contend that this regulation is invalid

* Sitting by designation.

because the only permissible interpretation of the relevant provisions of the Internal Revenue Code is that the amount of such a deduction must be the fair market value of the property that is distributed. The district court sustained the validity of the regulation. We affirm.

The tax on personal holding companies, 26 U.S.C. §§ 541-47 (hereinafter "26 U.S.C." will be omitted from all statutory citations), is one of several devices Congress has developed to prevent individuals from taking advantage of the fact that the maximum income tax rate is substantially lower for corporations than it is for individuals. To discourage individuals with substantial investment income from incorporating their "pocketbooks", thereby avoiding taxation of that income at the higher individual tax rates, the Congress imposed a penalty tax on the undistributed income of those corporations which it determines are probably operating for tax avoidance objectives. The Code defines a corporation as a "personal holding company" for a given tax year if 60 per cent or more of its stock is owned, actually or constructively, by five or fewer individuals and if 60 per cent or more of its adjusted gross income is "personal holding company income", which is defined in § 543 as primarily passive investment income. *See* § 542. The Code imposes a 70 per cent tax on the company's "undistributed personal holding company income", its taxable income with specified adjustments. *See* §§ 541, 545(a). One such adjustment to the corporation's taxable income is a deduction for dividends that are paid. The issue in this case concerns the proper method to value such dividends.

Appellants are the successors of the Pierce Investment Company (Company), a taxpayer which the Internal Revenue Service (IRS) found to be a personal holding company for the tax years 1959 through 1963 and for which the IRS proposed a personal holding company tax of $26,571.30. In an attempt to eliminate this tax, the Company declared a

dividend in the amount of $32,535 and tried to satisfy its declaration by distributing stock which had a fair market value of that amount, but in which the Company had an adjusted basis of $18,725.11.[1] The IRS subsequently disallowed the Company's claim for a deficiency dividend of $32,535 to the extent that the amount claimed exceeded the Company's adjusted basis in the property that was distributed. In taking this action, the IRS relied upon the Treasury Regulation on Income Tax, § 1.562-1(a), which provides as follows:

> "If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution."

The Company paid the resulting deficiencies in full, and appellants instituted this action for a refund in district court, claiming that the regulation in question is invalid.

In considering appellants' attack on this regulation, we begin by observing that Treasury regulations are entitled to deference. "As 'contemporaneous constructions [of the Internal Revenue Code] by those charged with administration of' [it], the Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and should not be overruled except for weighty reasons." *Bingler* v. *Johnson,* 394 U.S. 741, 749-50 (1969) *quoting from Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, 501 (1948). *See also United States* v. *Correll,* 389 U.S. 299 (1967). Although the one other circuit court of appeals that has considered this issue has concluded that the

[1] Although the relevant tax years had ended, § 547 and § 563 authorized the Company to reduce or eliminate its personal holding company tax by making an agreement with the IRS concerning the amount of its tax liability and then making a "deficiency dividend distribution" within 90 days of the agreement.

regulation is invalid, *see H. Wetter Mfg. Co.* v. *United States,* 458 F.2d 1033 (6th Cir. 1972), we are satisfied that the regulation is a reasonable interpretation of the revenue statutes and, as such, is valid.

We note at the outset that this regulation, which was adopted under the Internal Revenue Code of 1954, substantially reflects the rule which has been established by statute prior to 1954, but which had not been expressly reenacted in 1954. Section 27(d) of the Internal Revenue Code of 1939 expressly provided that the amount of a deduction for dividends paid in kind was either the corporation's adjusted basis in the property or the fair market value thereof, whichever was less. Here, the issue is whether Congress, by failing to include old § 27(d) in the 1954 revision of the Internal Revenue Code, intended both to preclude the Treasury Department from adopting a regulation which generally embodied the terms of the pre-1954 law, and to prescribe that it instead adopt a rule valuing the deduction for dividends paid in kind on a fair market value basis. We see no evidence that Congress intended such a result. Indeed, what evidence there is supports the validity of the regulation. Moreover, we think that the rule based upon old § 27(d) is entirely consistent with the broad objectives of the personal holding company tax, and that the contrary rule would both defeat the underlying policy of the act and produce results which would be difficult to justify rationally.

Although the 1954 Code, which has not been amended in any respect which is significant to this case, did not prescribe the method of valuing a dividends paid deduction, the legislative history of the 1954 Code indicates that Congress contemplated that the rule of old § 27(d) was to be carried over into the 1954 revision. The Senate Finance Committee Report on § 562(a) stated as follows:

> "Subsection (a) provides that the term 'dividend' for purposes of this part shall include, except as other-

wise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). *The requirements of sections 27(d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312 and accordingly are not restated in section 562."* [Emphasis supplied.] S. Rep. No. 162, 83d Cong., 2d Sess., 3 U.S.C. Cong. & Adm. News 4621, 4965-66 (1954).

See also H. Rep. No. 1337, 3 U.S.C. Cong. & Adm. News 4017, 4320 (1954). Although the language of this report is ambiguous in several respects and may not support the government's claim that it indicates that § 312 is to govern such matters,[2] this report certainly indicates that Congress did not contemplate the abrogation of the rule of old § 27(d).

And there is nothing in the Code which suggests that Congress in fact intended that the deduction for dividends paid in kind be based on the fair market value of the property. Indeed, to the extent that there is anything relevant in the Code, it appears to be consistent with the regulation that is under attack. Section 561, which defines the deduction, and §§ 562 and 316, which determine which distri-

[2] Although the United States argues that this legislative history clearly indicates that Congress intended that § 312—which, as we note, is consistent with, but does not compel, the rule under attack—would determine the amount of a dividends paid deduction, the committee report is ambiguous. The italicized sentence's description of § 312 as "defining" the term dividend apparently refers to the role that § 312 played in the House version of the bill. The House § 312 was amended by the Senate and became § 316, which, as we will indicate, does not deal with the issue at hand. Although we note that a comparison of Code § 312 with the sections of the 1939 Code referred to in the italicized sentence suggests that the Senate Report may have had Code § 312 in mind, we cannot eliminate the inference that the reference to § 312 may have simply been a typographical error. Therefore, we do not rely upon this legislative history for the proposition the government urges.

butions qualify for it, are silent[3] as to the valuation of the personal holding company's deduction.[4] The only provisions of the Code which offer any guidance on this question do not appear to be directly relevant, but they seem generally supportive of the validity of the regulation and in no way suggest that the rule embodied therein is inconsistent with the statutory scheme.

Section 312 is the only provision of the Code which, to our knowledge, deals specifically with the effect of a corporate distribution on the distributing corporation. It provides that a dividend that is paid in property will have the effect of decreasing a corporation's earnings and profits by the amount of the corporation's adjusted basis in the property. Although we understand that the payment of a dividend by an ordinary corporation does not give rise to a corporate deduction, and that this section, in its normal operation, only determines the tax effects of present and future corporate distributions on the corporation's shareholders, *see* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.24, we think this

[3] Even if other provisions in the Code support the regulation, appellants urge that we must hold it invalid because § 562, under which it was issued, does not directly support the regulation. This argument is strained. Since § 562 specifically deals with the subject of the dividends paid deduction—which applies to provisions other than the personal holding company tax—one would expect to find the rules governing its use in the regulations promulgated under § 562. If the regulation in question is consistent with the terms and policy of the revenue act—which it is—we do not believe it is rendered invalid because the specific statutory support for it is arguably found not in § 562 but elsewhere in the Code.

[4] Section 561 is purely definitional. Section 562 deals with several aspects of the problem of eligibility for the deduction, but refers to § 316 for the definition of dividend. Section 316, in turn, provides that a distribution is a dividend to the extent of a corporation's "earnings and profits", § 316(a), and that a distribution in property by a personal holding company will be a dividend to the extent of the company's "undistributed personal holding company's income". § 316(b).

section strongly suggests that Congress believed that, as far as the distributing corporation is concerned, the amount of a dividend in kind is the corporation's basis in the property. Certainly § 312 rebuts any contention that, as to the distributing corporation, the "plain meaning" of the term "dividend" is that it is equal to the fair market value of any property that is distributed, *but see H. Wetter Mfg. Co.* v. *United States, supra,*[5] or that Congress clearly manifested an intention to abrogate the rule of old § 27(d).[6]

The second provision of the Code — which appellants rely upon — is § 301, which defines the tax consequences of a corporate distribution on the recipient thereof. It provides "the amount distributed" to a recipient is the fair market value of the property received, in the case of a noncorporate distrubutee, or the distributing corporation's adjusted basis of the property (plus any gain that is recognized to the distributing corporation) in the case of a corporate distributee. To the extent that the distribution

[5] In concluding that the regulation under attack is invalid, the *Wetter* court reasoned that § 301, which determines the effect of a corporate distribution on a recipient, established that the "plain meaning" of § 562's reference to dividend is that such dividends are valued on a fair market value basis, and that, given the "plain meaning" of the statute, it would be improper to consider any other aids to its interpretation. *See H. Wetter Mfg. Co.* v. *United States, supra,* 458 F.2d at 1035-36. Although we doubt that we would have refused to consider the legislative history and objectives of the personal holding company tax even if we agreed with this approach to § 562, § 312 persuades us that § 562 has no such "plain meaning". Our consideration of the legislative history and purposes of the provisions in question compel the conclusion that the regulation is valid.

[6] Indeed, it is possible to read § 312 and § 316(b) as prescribing the rule in the regulation under attack. Section 316(b) suggests that, as to distributions in property by personal holding companies, the term "undistributed personal holding company income" may be substituted for "earnings and profits" wherever the latter appears in the Code. If § 316(b) were conceived of as having this implication, § 312 would announce the rule contained in the regulation.

qualifies as a dividend under § 316, the amount distributed will be ordinary income to the recipients. *See* § 61. Although § 301 is one of the few places in the Code where the phrase "amount distributed" appears, we can see no reason to treat it as establishing the rules for determining the amount of a personal holding company's dividends paid deduction. It, of course, deals only with the effect of a distribution on the recipients, and is thus less relevant than § 312. Moreover, were § 301 determinative, the amount of a corporation's dividends paid deduction would depend upon the character of the recipient, an anomaly which we strongly doubt Congress could have intended.

Although the evidence is that Congress clearly did not intend to abrogate the rule of old § 27(d) and probably intended to carry it over substantially, the consideration we ultimately find most persuasive is that appellants' approach would significantly undercut the effectiveness of the personal holding company provisions and would produce results which, in our view, would be irrational in light of the objectives and structure of this tax. The personal holding company tax, as we have noted, was enacted to combat the tax avoidance that could result from the accumulation of income from passive investment activity in a closely held corporation. It operates to force both the distribution of such earnings and the realization of dividend income at the shareholder level by imposing a penalty tax on the undistributed *income* which had been *realized* by such corporations during given tax years. Appellants' proposed approach would permit a corporation, which had distributed property representing substantially unrealized appreciation, to continue to accumulate the income it had realized on its investments during the relevant tax year — without being under any compulsion to distribute such earnings. The net effect would be that the corporation, and hence the shareholders, could succeed in shielding passive invest-

ment income from the operations of the personal holding company tax, contrary to the clear intent of these provisions.[7] By basing the deduction for dividends paid on the amount of the corporation's investment in the property distributed, the regulation prevents any such income shielding.[8]

Appellants' approach, moreover, would produce results which we would find impossible to square with the structure and operation of this tax. Whether a corporation is a personal holding company and the amount of its personal holding company tax liability depends upon the amount and nature of the corporation's income during a given tax year. Under appellants' proposal, personal holding companies,

[7] Appellants claim that the policy of the personal holding company tax compels the acceptance of their claim that § 301 should be determinative of the amount of any deduction. They trace the history of this tax and assert that the objective of these provisions has always been to compel corporate distributions which will result in ordinary income to the shareholders of an amount that is equal to, but not greater than, the corporation's "undistributed personal holding company income" prior to the distribution. It follows, they insist, that the amount of a dividends paid deduction should be equal to the amount of income that will be recognized at the shareholder level—that is, when, as here, the recipients are individuals, the fair market value of the property. The short answer to this argument is that § 27(d) of the 1939 Code plainly adopted a contrary policy; it simply is not the case that the policy has "always been" as they assert. More significantly, our analysis of the 1954 revision of the Code has persuaded us that Congress did not intend to abandon the policy embodied in old § 27(d).

[8] Appellants note that the regulation under attack has the same effect as a rule which provides that a corporation realizes a gain whenever it distributes appreciated property and then permits a deduction based on the fair market value of the property. This result, they suggest, is contrary to the policy of § 311, which provides that a corporation that distributes appreciated property only recognizes a gain in special circumstances, none of which are present in the case at bar. The short answer to this argument is that § 311 states the rule for ordinary corporate distributions, which do not give rise to corporate deductions. That corporate distributions which give rise to deductions should be treated differently is required by the objectives of this tax.

which had identical amounts of taxable income and which had invested identical amounts in the assets which produce their respective incomes, could have completely different tax liabilities after distributing assets representing the same level of corporate investment. The disparate treatment would not arise from any differences in their tax situation during the tax year in question, but from the fact that the assets which they had distributed had appreciated at different rates during the period prior to that tax year.

Since we think the regulation in question is entirely consistent with the objectives and terms of the revenue act, we hold that the district court was correct in sustaining the validity of this regulation against appellants' attack and in rejecting appellants' claim for a refund.

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

Civil Action No. 73-1109-M

ARTHUR S. FULMAN ET AL.,
PLAINTIFFS,
v.
UNITED STATES OF AMERICA,
DEFENDANT.

MEMORANDUM and ORDER

MURRAY, D.J. This case came on to be considered on the respective motions of plaintiffs and defendant for summary judgment, the parties having stipulated all material facts and waived oral argument. The sole issue may be stated as follows:

> For purpose of computing the deduction provided by Section 545 of the Internal Revenue Code (Code) of 1954 (the deduction for dividends paid under the personal holding company tax), is a dividend paid by a holding company with the securities of other corporations to be valued to the holding company at the company's adjusted basis of the securities or at their fair market value at the time of distribution?

This same issue was considered in *H. Wetter Manufacturing Co.* v. *United States*, 458 F.2d 1033 (6th Cir. 1972). There the court undertook to journey through the Code seeking resolution of the issue in the following language:

> In determining how Congress wished the deduction to be computed, we start with Section 545 of the Code. This section provides that the undistributed personal holding company income is the taxable income of the personal holding company adjusted as allowed by law

> and minus ". . . the dividends paid deduction as defined in section 561." Section 561 provides that the rules provided in section 562 and 563 shall be applicable in determining the deduction for dividends paid. Section 562 provides that ". . . the term 'dividend' shall, except as otherwise provided in this section, include only dividends described in section 316 . . ." Section 316 provides that if the distributing corporation is a personal holding company during the year in which the distribution is made, ". . . the term 'dividend' also means any distribution of property . . . made by the corporation to its shareholders, to the extent of its undistributed personal holding company income . . . for such year."

Id. at 1034.

After considering the contentions and briefs of the parties, the court agrees with, and adopts, the quoted language as relevant to the issue here. However, the court is not persuaded to follow *Wetter* beyond the quoted language, particularly where it referred to section 301(d)(1), seemingly as bearing upon the computation of the dividends deduction in the hands of the distributing personal holding company, and rejected the Treasury Regulation 26 C.F.R. § 1.562-1(a) as inconsistent with the Code. The court agrees with *Wetter* that "[a] Court may not enforce a regulation which is plainly inconsistent with the revenue statute" (*id.* at 1035), but, with respect, disagrees that the "plain meaning" rule of statutory construction resolves the issue. *Cf.* D. Kahn, Basic Corporate Taxation 195 (1973); 51 Tex. L. Rev. 368 (1973).

From a consideration of the arguments of the parties and analysis of the pertinent provisions of the Code, the court reaches the following conclusions:

(1) Section 301 of the Code does not unambiguously support plaintiffs' contention that valuation at fair market

value of the dividend is the proper construction of section 562 of the Code in resolving the issue here. Considered together, sections 301 and 316[1] are not clearly dispositive of the issue. Section 301(d)[2] speaks only of the valuation of a corporate dividend received by a shareholder-distributee; it does not by its terms purport to govern the effect of the distribution on the corporate-distributor of property distributed as a dividend. Accordingly, the court respectfully declines to follow the holdings of *Wetter* and *Gulf Inland Corp.* v. *United States,* 36 AFTR 2d 75-5511 (W.D. La. 1975).

(2) Section 312 of the Code does not establish a yardstick of valuation for determining the amount of dividends paid deduction by a personal holding company at the company's adjusted basis in the property distributed, as defendant contends. Section 312 provides for valuation of a distribution as a dividend only in relation to a corpo-

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[1] 26 U.S.C. § 316, in pertinent part, provides:

(a) . . . To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

[2] 26 U.S.C. § 301, in pertinent part, provides:

(d) *Basis.*—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) *Noncorporate distributees.*—If the shareholder is not a corporation, the fair market value of such property.

(2) *Corporate distributees.*—If the shareholder is a corporation, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311, under section 341(f), or under section 617(d)(7), 1245(a) or 1250(a).

ration's earnings and profits. Section 316(b)(2)(A), however, contemplates that a distribution by a personal holding company may be treated as a dividend even if it is in excess of the corporation's earnings and profits. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations ¶ 8.25 n.102 (3rd ed. 1971).

(3) Where the statutory provisions relied upon by the parties do not unambiguously support their respective contentions as to the construction of section 562 of the *Code* in determining the basis for computing the dividends paid deduction, the court may properly consider the legislative history of section 562 as an aid to its construction. *Cf. Commissioner* v. *Bilder,* 369 U.S. 499 (1962), *rev'g* 289 F.2d 291 (3rd Cir. 1961).

(4) That history, derived from the committee reports, specifically refers to section 27(d) of the Internal Revenue Code of 1939 as being "incorporated" and "contained" in the 1954 Code. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A181 (1954), 1954 U.S. Code Cong. & Admin. News 4320;[3] S. Rep. No. 1635, 83rd Cong., 2d Sess. 325 (1954), 1954 U.S. Code Cong. & Admin. News 4965-66.[4] Section 27(d)

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[3] The House Report reads as follows:

SECTION 562. *Rules applicable in determining dividends eligible for dividends paid deduction*

Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 312 (relating to definitions of dividends for purposes of corporate distributions). The requirements of sections 27(d), (e), (f), and (i) of existing law are incorporated in the definition of "dividend" in section 312, and accordingly are not restated in section 562.

[4] The Senate Report reads as follows:

SECTION 562. *Rules applicable in determining dividends eligible for dividends paid deduction*

This section conforms to section 562 of the House bill except for a clerical amendment.

Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (re-

provided that the dividends paid credit for personal holding company taxes was to be computed at "the adjusted basis of the property in the hands of the corporation at the time of payment, or the fair market value of the property at the time of payment, whichever is lower". 26 U.S.C. § 27(d) (1952).[5] The valuation standard of section 27(d)

lating to definition of dividends for purposes of corporate distributions). The requirements of sections 27(d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312, and accordingly are not restated in section 562.

[5] Some explanation of the legislative history as it refers to the incorporation of section 27(d) of the 1939 Code in the 1954 Code is required. The House Report places the requirements of section 27(d) in section 312 of the House Bill. The Senate Report, while by terms also placing the requirements of section 27(d) in "section 312", raises the inference that the Senate actually meant that requirements of section 27(d) had been placed in section 316 of the Senate Bill. This inference is supported by several pieces of circumstantial evidence. Section 316 of the Senate Bill, which became section 316 of the 1954 Code, was originally section 312 of the House Bill. The first sentence of the two-sentence Senate discussion of section 562(a) (which otherwise reproduces the House discussion almost verbatim) makes the numbering adjustment from section 312 of the House Bill to section 316 of the Senate Bill. Yet the second sentence of the Senate discussion makes continued and unaccountable reference to "section 312". Finally, the reference in the Senate discussion to section 312 is factually incorrect. The Senate Report states that the requirements of section 27(d) "are contained in the definition of 'dividend' in Section 312 . . . ." In point of fact, however, there is neither a definition of nor even a reference to the term "dividend" in section 312. It was section 316 of the Code as enacted and not section 312 that Congress denominated as "Dividend defined". Based upon examination of the legislative history of section 562, the court must conclude that the reference to "section 312" in the second sentence of the Senate Report's discussion of section 562(a) is a typographical error. Further, the court must agree with plaintiffs that defendant is erroneously relying upon section 312 of the Code as the valuation provision for the personal holding company tax.

In addition to negating the relevance of the specific provision relied upon by the defendants, however, the legislative history of section 562 also plays an affirmative role in construction of the Code. The portion of the legislative history relevant for purposes

relevant to the issue here is embodied in the Treasury Regulation, 26 C.F.R. § 1.562-1(a),[6] which permits a dividends paid deduction by the personal holding company only to the extent of the holding company's adjusted basis of the property distributed. The court will defer to the regulation promulgated by the Commissioner of Internal Revenue acting within his statutory authority unless it should appear that the regulation is plainly inconsistent with the Code or is unreasonable.

(5) The regulation is not in conflict with sections 301, 316 or 562 of the Code, and nothing has been presented to the court to demonstrate inconsistency with any other sections. In light of the clear Congressional intention evidenced in the legislative history of section 562 to implant the valuation principle of section 27(d) of the 1939 Code in the 1954 Code, and the Congressional purpose in enact-

of construction of section 562 is the expressed Congressional intent to incorporate section 27(d) of the 1939 Code. After allowance is made for the typographical error in the Senate Report, it appears clear from the legislative history that Congress believed it was incorporating the requirements of section 27(d) in section 316 of the 1954 Code.

The plaintiffs, therefore, are correct in asserting that the legislative history of section 562 is marred by typographical error and that once this typographical error is accounted for it becomes clear that Congress did not intend section 312 of the 1954 Code to provide a valuation provision for the corporation's distribution of securities. Nevertheless, the substance of the defendant's contention that the legislative history here supports the result it seeks is unimpaired by close examination of the primary texts relied upon by Congress in considering the 1954 Code.

[6] 26 C.F.R. § 1.562-1(a), in pertinent part, provides:

(a) *General rule.* Except as otherwise provided in section 562 (b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). . . . If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. . . .

ing the undistributed personal holding company tax, there is nothing unreasonable in a regulation permitting disparity between the valuation of the property distributed as dividends, when allowed as a deduction to the personal holding company in computing its taxable undistributed income, and the valuation of the same property when subject to the tax imposed upon income to shareholders. Even if the personal holding company tax, 26 U.S.C. § 541 *et seq.*, is a penalty, and therefore to be construed narrowly against defendant, *Commissioner* v. *Acker*, 361 U.S. 87 (1959), where the Congressional purpose is explicitly revealed in the legislative history,[7] the Treasury Regulation is consistent with that purpose, and there is no statutory language that supports the construction urged by the taxpayer, the court will accord full weight to the regulation. *See Commissioner* v. *Bilder, supra* at 504.

Accordingly, defendant's motion for summary judgment is granted, and plaintiffs' motion is hereby denied.

(s) FRANK J. MURRAY
United States District Judge

Dated: January 22, 1976

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[7] *Cf. Ivan Allen Co.* v. *United States*, 422 U.S. 617 (1975). The Supreme Court in the last term illustrated the manner in which technical valuation issues surrounding a penalty tax are to be addressed in *Ivan Allen* when it construed certain provisions of the accumulated earnings tax, a tax, like the personal holding company tax, designed by Congress to minimize the opportunities for tax avoidance offered by the differential between personal and corporate income taxes. *Ivan Allen* noted that the accumulated earnings tax was "a penalty and therefore to be strictly construed". *Id.* at 627. Nevertheless, the Court also felt bound to construe the statute in light of the purpose envisioned for the tax evidenced by the structure of the accumulated earnings provisions. *Id.* at 626-27. After doing so the Court found in favor of the Government. The analysis that the court gives here to the personal holding company tax is similar to that given the accumulated earnings tax by the Court in *Ivan Allen*. For even conceding that the statute must be strictly construed against the defendant here, the court must give full weight to the Congressional intent evidenced in the legislative history.

APPENDIX C

Statutory Provisions Involved

INTERNAL REVENUE CODE OF 1954, AS AMENDED, UNITED STATES CODE, TITLE 26

Sec. 541. Imposition of Personal Holding Company Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

Sec. 545. Undistributed Personal Holding Company Income.

(a) *Definition* — For purposes of this part, the term "undistributed personal holding company income", means the taxable income of a personal holding company adjusted in the manner provided in subsections (b), (c), and (d), minus the dividends paid deduction as defined in section 561. In the case of a personal holding company which is a foreign corporation, not more than 10 percent in value of the outstanding stock of which is owned (within the meaning of section 958(a)) during the last half of the taxable year by United States persons, the term "undistributed personal holding company income" means the amount determined by multiplying the undistributed personal holding company income (determined without regard to this sentence) by the percentage in value of its outstanding stock which is the greatest percentage in value of its outstanding stock so owned by United States persons on any one day during such period.

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Sec. 547. Deduction for Deficiency Dividends.

(a) GENERAL RULE — If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of deficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

* * * *

(d) DEFICIENCY DIVIDENDS —

(1) *Definition* — For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

(2) *Effect on Dividends Paid Deduction* —

(A) *For Taxable Year in Which Paid* — Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year and succeeding years.

(B) *For Prior Taxable Year* — Deficiency Dividends paid in any taxable year (to the extent of the

portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be allowed for purposes of section 563(b) in the computation of the dividends paid deduction for the taxable year preceding the taxable year in which paid.

* * * *

Sec. 561. Definition of Deduction for Dividends Paid.

(a) GENERAL RULE — The deduction for dividends paid shall be the sum of —

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) SPECIAL RULES APPLICABLE —

(1) In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

* * * *

Sec. 562. Rules Applicable in Determining Dividends Eligible for Dividends Paid Deductions.

(a) GENERAL RULE — For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

* * * *

Sec. 316. Dividend Defined.

(a) GENERAL RULE — For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) SPECIAL RULES —

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(2) Distributions By Personal Holding Companies —

(A) In the case of a corporation which —

(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provision of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the

extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

• • • •

Sec. 301. Distributions of Property.

(a) IN GENERAL — Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) AMOUNT DISTRIBUTED —

(1) *General Rule* — For purposes of this section, the amount of any distribution shall be —

(A) *Noncorporate Distributees* — If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) *Corporate Distributees* — If the shareholder is a corporation unless subparagraph (D) applies, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251 (c) or 1252(a).

• • • •

(2) *Reduction for Liabilities* — The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by —

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) *Determination of Fair Market Value*—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) AMOUNT TAXABLE — In the case of a distribution to which subsection (a) applies —

(1) *Amount Constituting Dividend*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * *

(d) BASIS — The basis of property received in a distribution to which subsection (a) applies shall be —

(1) *Noncorporate Distributees* — If the shareholder is not a corporation, the fair market value of such property.

(2) *Corporate Distributees*—If the shareholder is a corporation, unless subparagraph (3) applies, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), or 1252(a).

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